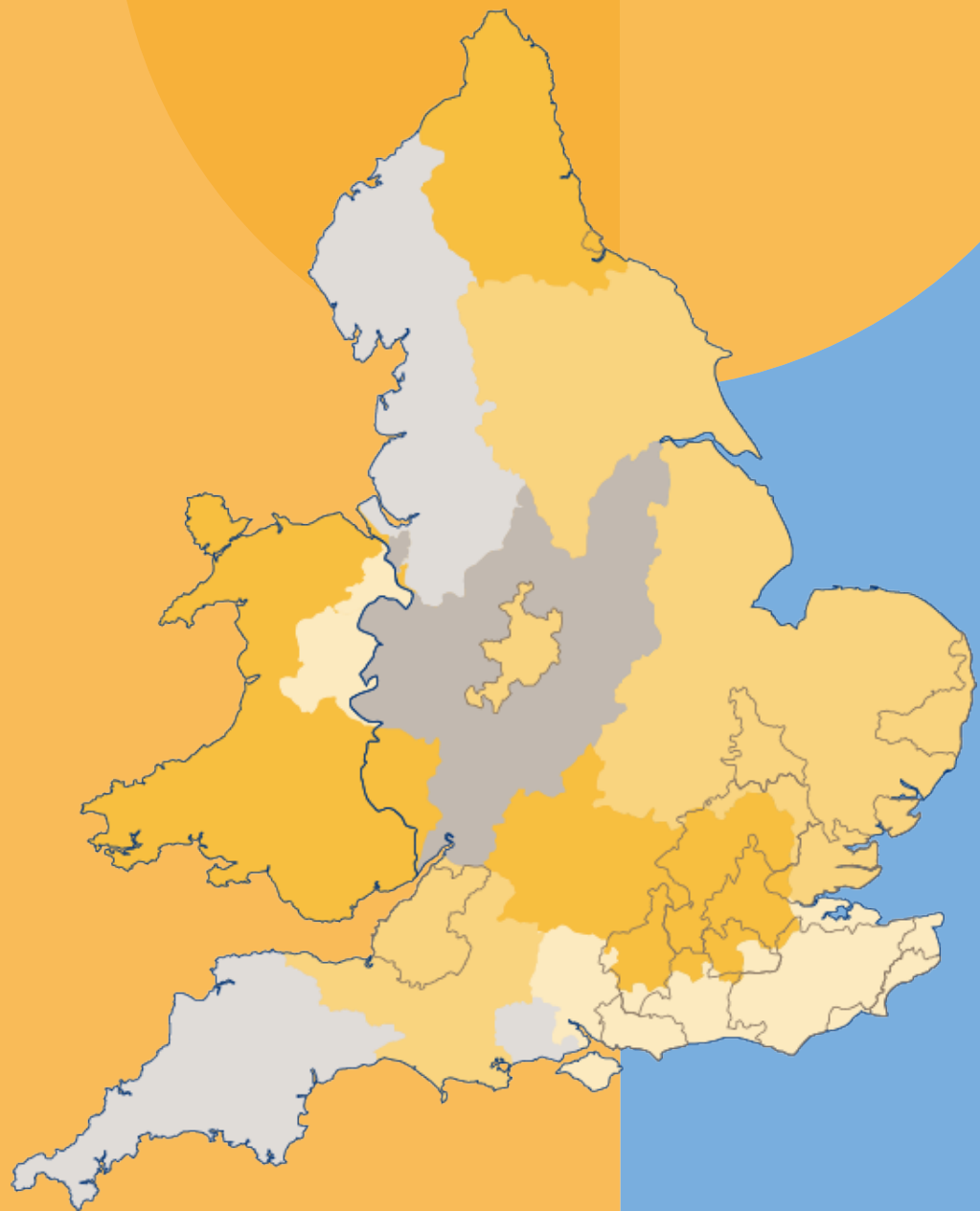


# PR19 draft determinations

## Notification of the PR19 draft determination of Price Controls for Portsmouth Water



# 1 Notification of the draft determination of price controls for Portsmouth Water Limited

## 1.1 About this document

Every five years we set the price, service and incentive package for monopoly water companies. This document sets out for consultation the draft determination of the formal price controls for Portsmouth Water Limited (**Portsmouth Water**) which will apply over the 2020 to 2025 period.

This first section provides an introduction to how the price controls will operate. The rest of the document is structured as follows:

- our proposed approach to the designation of activities to be included in the water resources and retail controls;
- the draft price control for network plus water activities;
- the draft price control for water resources activities;
- the draft price control for residential retail activities;
- the proposed assumptions on notified items and land sales;
- the proposed performance commitments that could lead to changes in the price controls during the 2020 to 2025 period to reflect the water company's performance; and
- the proposed revenue forecasting incentive (RFI) formula that we intend to apply, subject to a proposed licence modification.

This document has been published on our website. We are also publishing information on our general approach and the reasons for our draft decisions. For all other documents relating to the Portsmouth Water draft determination please see the [draft determinations webpage](#).

## 1.2 Background

The 2019 price review (PR19) will set out the price, service and incentive package that will apply to monopoly water companies for the 2020 to 2025 period. In the PR19 methodology we consulted on our approach to setting price controls, building on the work that we had undertaken as part of the Water2020 programme. Our approach to setting price controls as part of PR19 reflects a number of changes from the approach taken at the 2014 price review (PR14). These include:

- determining separate wholesale controls for water resources and network plus water activities;

- the change in the measure of inflation used to index controls, replacing the retail price index (RPI) with the consumer price index including owner occupiers' housing costs (CPIH);
- a move to more in-period rather than end of period outcome delivery incentives (ODIs); and
- replacing the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) with the RFI.

We summarise our general approach to the key elements below.

### 1.2.1 Designation of activities

We need to designate the activities that are included in the new water resources price control. Our designation of activities follows the approach we set out in the PR19 Methodology. Where appropriate, we cross-refer to updated definitions in our Regulatory Accounting Guidelines (RAGs) that we provide to companies.

We are not proposing any change to the designation of retail activities. The definition of these activities would therefore remain the same as it was for PR14.

### 1.2.2 Form of control

In our PR19 methodology we set out the form that each control would take. In the formal price controls below we have included in-period adjustments<sup>1</sup> which would apply automatically. We have excluded in-period adjustments made through in-period determinations i.e. in-period ODIs.

Below, we set out the some of the specific considerations for each control.

**Network plus activities:** For network plus activities the form of control is determined in licence condition B (Charges). Allowed revenue changes each year in line with inflation, CPIH, and a factor we determine, 'K'. Due to the constraints of the condition, further potential adjustments to the level of these controls (e.g. to accommodate the RFI and blind year adjustments) are addressed separately.

**Water resources:** We have structured the control in the same way as for network plus activities. In our PR19 methodology we set out the adjustment mechanism for changes to water companies' allowed revenue once the bilateral market opens. Adjustments will be based on the difference between forecast and actual bilateral

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<sup>1</sup> End-of-period adjustments are not included because, by definition, allowed revenues would be adjusted at the end of the price control period.

market entry, but will only be made if a company invests in new water resource capacity after 1 April 2020. Our control allows for possibility that the bilateral market will open in the 2022-23 charging year. We envisage that the in-period adjustment for bilateral entry will have a two-year timing delay between the charging year when any entry occurs and the charging year allowed revenues could change. This is because any difference between forecast and actual bilateral entry will not be reported by water companies until after the relevant charging year when it occurs; and it would only be practical for any adjustment to allowed revenues to take effect the year after this report.

**Residential retail:** The residential retail control is an average revenue control. Allowed revenue is adjusted to reflect the difference between actual and forecast customer numbers. Our control does not distinguish between classes of customer, reflecting our assessment of companies' costs.

**Havant Thicket reservoir:** We also propose to include in our final determination a separate price control covering the Havant Thicket reservoir. This proposed price control would apply for a ten-year period and limit the revenue that could be recovered from Portsmouth Water's customers for activities related to the development of the Havant Thicket reservoir. We provide further details in the **PR19 draft determinations: Havant Thicket policy issues appendix**. We have not included draft wording for the price control in this document because the separate price control will require a licence modification that has not yet been made.

**Revenue forecasting incentive:** In our PR19 methodology document we said that we would introduce the RFI to apply a revenue correction adjustment and a financial incentive to each charging year's recovered revenue for the network plus and water resources controls. The draft RFI formula is set out in Appendix 3. We are proposing a licence modification to make sure that such in-period adjustments are allowed during the 2020 to 2025 period and future price control periods. This will be equivalent to the licence modification we made for most companies in 2016 to implement the WRFIM in the current price control period.

### 1.2.3 Outcomes

We can change the level of price controls during the 2020 to 2025 period to reflect performance commitments, provided those performance commitments are notified to the company by 31 December 2019.

The PR19 methodology encourages companies to make more of their performance commitments subject to in-period assessment of ODIs rather than end-of-period. In Appendix 2 we set out for consultation the company's performance commitments which have in-period financial ODIs along with the price controls to which they apply.

In relation to common performance commitments with financial ODIs, companies have put forward a variety of proposed allocations across price controls. We accept that there may be good reasons for these differences and at this stage we have accepted the proposed allocations. We will consider further whether this is an appropriate approach for slow track and significant scrutiny draft determinations in July and for final determinations for all companies in December.

We said in the PR19 methodology that we expect companies to propose approaches to protecting customers in case their ODI payments turn out to be much higher than expected. We explained in the initial assessment of business plans [Technical appendix 1: Delivering outcomes for customers \(January 2019\)](#) that we are asking all companies to commit to put in place additional protections for customers, where we consider protections are not adequate to protect customers from high outperformance payments.

The company proposes adopting a customer protection mechanism where any incremental outperformance payments in any year above 3% Return on Regulatory Equity (RoRE) would be rolled forward to be taken later in the following years when the 3% threshold is not breached. If there is still any incremental outperformance at the end of 2020-25, the company proposes to share it 50:50 between customers and the shareholder via additional expenditure on issues important to customers or lower bills for customers. We intervene to apply our standard mechanism where 50% of outperformance payments that exceed 3% of RoRE in any year are shared with customers through bill reductions in the following year. We are undertaking further work on the detail of the mechanism and the process for annual reconciliation. We will publish our final decisions on these aspects of the mechanism (including how it will affect the in-period assessment of ODIs) as part of the final determinations in December 2019.

As well as the performance commitments set out in Appendix 2, we also propose to include in our final notification the company's existing performance commitments that cover 2019-20 and have financial ODIs. This will allow us to adjust price controls during the 2020 to 2025 period (instead of waiting until the 2024 price review) to reflect any differences between the assumptions about 2019-20 performance we use when setting the 2020 to 2025 price controls and actual 2019-20 performance. We are not publishing these performance commitments at the draft determination stage because have already been published as part of the PR14 final determinations and will not be changing. Because any such adjustments would relate to performance in the current (2015 to 2020) price control period, they will not be covered by the above mechanism to protect customers from higher than expected outperformance payments in relation to the 2020 to 2025 period.

## **2 Notification by the Water Services Regulation Authority of the draft determination of Price Controls for Portsmouth Water Limited**

This document sets out for consultation the draft determination by the Water Services Regulation Authority (“Ofwat”) of the Price Controls for Retail Activities, Network Plus Water Activities and Water Resources Activities.

The final determination of the Price Controls will be made by Ofwat in December 2019 in accordance with Part III of Condition B (Charges) of your Appointment as a water undertaker:

- after having had regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to Ofwat’s determinations, including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur; and
- in accordance with the statement setting out strategic priorities and objectives for Ofwat published by the Secretary of State for Environment, Food and Rural Affairs.

The Price Controls, when they take effect, will all apply for the five consecutive Charging Years starting on 1 April 2020.

Unless the contrary intention appears, words and expressions used in this document shall have the same meaning as in the Conditions of the Appointment. Common terms used in the formulae in this document are defined in the Glossary set out in Appendix 4.

### **2.1 Designation of activities**

The sets of activities that Ofwat proposes will be covered by the relevant Price Controls are set out below.

#### **2.1.1 Network Plus Water Activities**

All activities carried out by the Appointee in performance of its functions as a water undertaker that are not designated as Water Resources Activities or Retail Activities will be Network Plus Water Activities.

## 2.1.2 Water Resources Activities

Ofwat proposes to designate as Water Resources Activities under sub-paragraph 8.9 of Condition B the activities carried out as part of the Appointed Business that fall within the definitions of the following services in [RAG 4.08 – Guideline for the table definitions in the annual performance report](#) (March 2019)<sup>2</sup>:

- Water resources – Abstraction licences; and
- Water resources – Raw water abstraction.

## 2.1.3 Retail Activities

Ofwat does not propose to change the activities that are currently designated as Retail Activities.

## 2.1.4 Wholesale activities not covered by wholesale price controls

The Price Controls in respect of Water Resources Activities and Network Plus Water Activities will not apply to those activities for which there are Excluded Charges. Excluded Charges (as defined in Condition B) include:

- charges for a supply of water in bulk to another water undertaker;
- amounts payable in respect of an unmeasured supply of water by means of stand-pipes or water tanks and in respect of the erection or maintenance of stand-pipes or water tanks;
- charges for a supply of water provided by the Appointee under section 59 (Supplies for other public purposes) of the Water Industry Act 1991;
- charges for unmeasured supplies of water to cattle troughs;
- charges for unmeasured building water supplies;
- amounts payable in respect of an unmeasured supply of water by means of bowsers or water tankers;
- charges for unmeasured supplies of water to farm taps and other agricultural water points; and
- amounts payable under any such agreement as is described in section 20(1)(b) of the Water Resources Act 1991; and
- charges payable under any agreement for any unmeasured supply of water which are calculated by reference to the rateable value of hereditaments,

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<sup>2</sup> Condition B sets the envelope of what activities can be designated as Water Resources Activities by reference to RAG 4.06, but Ofwat intends to actually designate Water Resources Activities in December 2019 by reference to the most recent version.

occupied by the person to whom the supply or services are provided, fixed in accordance with section 32, 33 or, as the case may be, 34 of the General Rate Act 1967 or, as the case may be, fixed in accordance with section 54 of the Local Government Finance Act 1988.

As part of the draft determination we are also consulting on whether the list of Excluded Charges for the purposes of Condition B should include amounts payable in relation to diversions other than those required by section 185 of the Water Industry Act 1991. This change would require agreement between Ofwat and the Appointee for the purposes of the definition of “Excluded Charges” in paragraph 2 of Condition B. In its response to the draft determination, the Appointee should therefore indicate whether or not it would be prepared to agree to this and whether it has any comments on the following proposed definition:

“In relation to the period from 1 April 2020 to 31 March 2025, amounts payable in relation to the alteration or removal of any relevant pipe (as defined in section 158 of the Water Industry Act 1991) or other apparatus that the Appointee is required to carry out under the New Roads and Streets Works Act 1991 or any other statutory provision except section 185 of the Water Industry Act 1991.”

## 2.2 Price Controls for Network Plus Water Activities

In respect of the Appointed Business’s Network Plus Water Activities, except those activities for which there are Excluded Charges, there will be one single Price Control in respect of the Appointed Business’s Network Plus Water Activities.

Such Price Control will consist of in each Charging Year:

- the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for the immediately preceding November; and
- a number, “**K**”, which may be a positive number or a negative number or zero

which together shall be expressed as a percentage, and which shall limit the change in the revenue allowed to the Appointed Business in each Charging Year in respect of the Network Plus Water Activities concerned.

For each Charging Year starting on or after 1 April 2021 the revenue allowed to the Appointed Business in respect of the Network Plus Water Activities concerned will be the product of the following formula:



$$R_t = R_{t-1} \times \left(1 + \frac{(CPIH_t + K_t)}{100}\right)$$

For the Charging Year starting on 1 April 2020 the revenue allowed to the Appointed Business in respect of the Network Plus Water Activities concerned is the product of the same formula except that  $R_{t-1}$  = the relevant revenue allowance (as set out below). This is because (as the form of Price Controls has since changed) at the last Periodic Review no revenue allowance in respect of Network Plus Water Activities was set for the Charging Year that started on 1 April 2019.

In respect of the Appointed Business’s Network Plus Water Activities, the starting point for the calculation of the change in the revenue allowed to the Appointed Business in the Charging Year starting on 1 April 2020 (the revenue allowance for Network Plus Water Activities) is **£27.735** million, which shall constitute the value of  $R_{t-1}$  in respect of that Charging Year.

The “**K**” numbers for each Charging Year are set out in Table 1.

**Table 1: Price Control for Network Plus Water Activities “K” numbers**

Charging Year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25
K number	0.00	1.98	1.95	3.23	4.31

## 2.3 Price Control for Water Resources Activities

The Price Control shall consist of, in each Charging Year:

- the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for the immediately preceding November; and
- a number, “**K**”, which may be a positive number or a negative number or zero

which together shall be expressed as a percentage, and which shall limit the change in the revenue allowed to the Appointed Business in each Charging Year.

For each Charging Year starting on or after 1 April 2021 the revenue allowed to the Appointed Business in respect of the Water Resources Activities concerned will be the product of the following formula:

$$R_t = R_{t-1} \times \left[ 1 + \frac{CPIH_t + K_t}{100} \right]$$

For the Charging Year starting on 1 April 2020 the revenue allowed to the Appointed Business in respect of Water Resources Activities is the product of the same formula except that  $R_{t-1}$  = the relevant revenue allowance (as set out below). This is because (as the form of Price Controls has since changed) at the last Periodic Review no revenue allowance in respect of Water Resources Activities was set for the Charging Year that started on 1 April 2019.

In respect of the Appointed Business’s Water Resources Activities, the starting point for the calculation of the change in the revenue allowed to the Appointed Business in the Charging Year starting on 1 April 2020 (the revenue allowance for Water Resources Activities) is **£4.681** million, which shall constitute the value of  $R_{t-1}$  in respect of that Charging Year.

The “**K**” numbers for each Charging Year are set out in Table 3.

**Table 3: Price Control for Water Resources Activities “K” numbers**

Charging Year beginning 1 April	2020-2021	2021-2022	2022-2023	2023-2024	2024-2025
K number	0.00	-4.25	-4.61	-13.67	-25.17

**Note:**

There is no Table 2 in this draft determination. This is a deliberate omission that is intended to ensure consistency in Table numbers between different companies.

**2.3.1 In-period adjustment to the Price Control for Water Resources Activities to account for bilateral entry**

For each Charging Year starting two or more years after the beginning of the Charging Year in which a new section 66B(1) is inserted into, or substituted for the existing section 66B(1) of, the Water Industry Act 1991 by paragraph 1 of Schedule 2 to the Water Act 2014 (“Bilateral Market Opening”) the revenue allowed to the Appointed Business in respect of the Water Resources Activities concerned will be calculated in accordance with the following formula:

$$R_t = R_{t-1} \times \left[ 1 + \frac{CPIH_t + K_t}{100} \right] + \left[ BEA_{t-2} \times (CPIH \text{ adjustment factor}_t) \times \left( 1 + \frac{D}{100} \right)^2 \right]$$

Where:

$$BEA_t = ICC_t \times AUC_t \times BEF_t$$

$$BEF_t = \left( \frac{TCC_t}{ICC_t + BCCa_t} \right) - 1$$

$$TCC_t = ICC_t + BCCf_t$$

**BEA<sub>t</sub> Bilateral entry adjustment.** The bilateral entry adjustment is expressed in 2017-18 FYA CPIH deflated prices. This value can be a negative number or zero but cannot be higher than zero (and any positive number shall therefore be considered as zero for the purposes of calculating the revenue allowed to the Appointed Business in respect of the Water Resources Activities concerned).

**WRZ Water resource zone.** This is the water resource zone (“WRZ”) used for the basis of the calculation in the relevant Charging Year, as listed in Table 4 below. The WRZ must have the same geographical boundaries as that WRZ has for the purposes of the draft water resources management plan published by the Appointee in 2018 in accordance with section 37B(2) of the Water Industry Act 1991<sup>3</sup>.

**ICC<sub>t</sub> Incumbent cumulative capacity.** The Appointee’s cumulative post-2020 forecast capacity (Ml/d), as set out in Table 4 below.

**AUC<sub>t</sub> Annualised unit cost.** The Appointee’s annualised unit cost of cumulative post-2020 capacity (£/ Ml/d) expressed in 2017-18 FYA CPIH deflated prices, as set out in Table 4 below.

**BEF<sub>t</sub> Bilateral entry forecast factor.** The bilateral entry forecast factor is:

- (i) the difference between actual bilateral entry capacity (BCCa<sub>t</sub>) compared to that forecast (BCCf<sub>t</sub>), as a proportion of total forecast post-2020 capacity (TCC<sub>t</sub>); and

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<sup>3</sup> Although this text refers to draft water resources management plans, where appropriate it will be updated to refer to final water resources management plans that are published before our final determinations.

(ii) a negative number or is zero.

**TCC<sub>t</sub> Total cumulative capacity.** The total forecast cumulative post-2020 capacity for the relevant year (t) as set out in Table 4 below.

**BCC<sub>a,t</sub> Bilateral cumulative capacity - actual.** The actual post-2020 third party bilateral capacity in the water resource zone in year t for the dry year annual average (DYAA) planning period, as measured using water resources yield. For these purposes:

- “actual post-2020 third party bilateral capacity” means the actual capacity available because of agreements that permit the introduction of water into the Appointee’s supply system in accordance with section 66B or section 66C of the Water Industry Act 1991; and
- water resources yield for the DYAA planning period must be calculated:
  - (i) in accordance with Appendix 2 (Water resources further guidance) to RAG 4.08 (as published by Ofwat in March 2019)<sup>4</sup>; and
  - (ii) in a manner consistent with the calculation of water resources yield for the DYAA planning period for the purposes of the draft water resources management plan published by the Appointee in 2018 in accordance with section 37B(2) of the Water Industry Act 1991.

**BCC<sub>f,t</sub> Bilateral cumulative capacity - forecast.** The forecasted cumulative post-2020 third-party bilateral capacity provided for the DYAA planning period, as used for WRMP19 and as measured using water resources yield in the water resource zone and as set out in Table 4 below.

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<sup>4</sup> RAG 4.08 Appendix 2 (Water resources further guidance) can be found at <https://www.ofwat.gov.uk/wp-content/uploads/2019/01/RAG-4.08-Appendix-2-post-condoc-v1.pdf>

**Table 4: Price Control for Water Resources Activities bilateral entry adjustment numbers**

Charging Year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25
Water resource zone: PRT					
AUC (£/ MI/d, 17-18 prices)	N/A	N/A	£32,777	£32,777	£24,357
ICC	N/A	N/A	7.80	7.80	20.30
BCCf	N/A	N/A	0.00	0.00	0.00
TCC	N/A	N/A	7.80	7.80	20.30

\* for final determination we will adjust these tables to reflect any efficiency challenges of schemes that contribute to new water resources capacity.

## 2.4 Price Control for Residential Retail Activities

In respect of the Appointed Businesses' Retail Activities, Ofwat proposes to set one single Price Control for the Appointed Business's Retail Activities relating to the supply of water to household premises (as defined in section 17C of the Water Industry Act 1991) ("**Residential Retail Activities**").

The Price Control for Residential Retail Activities:

- shall consist of a limit on the total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned; and
- is set for a period of five consecutive Charging Years starting on 1 April 2020.

The total unadjusted revenue, **TR**, allowed to the Appointed Business in each Charging Year in respect of Residential Retail Activities shall be the relevant amount set out in Table 6 as modified in accordance with the following formula:

$$R_t = TR_t + (AC_t - FC_t) \times M_t \times 1000$$

Where:

**TR<sub>t</sub> Total Revenue** The total unadjusted allowed revenue expressed in outturn prices as set out in table 6;

**AC<sub>t</sub> Actual Customers** Actual customer numbers (meaning the average number of individual household premises (as defined in section 17C of the Water Industry Act 1991) supplied or served by the Appointed Business in a Charging Year) expressed in thousands;

**FC<sub>t</sub> Forecast Customers.** Forecast customer numbers set out in table 6;

**M<sub>t</sub> Modification Factor.** The modification factors expressed in outturn prices set out in table 6.

**Table 6: Price Control for Residential Retail Activities numbers**

Charging year beginning 1 April	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
TR (£million, outturn)	4.945	4.958	4.972	4.985	4.999	-
M (£, outturn)	16.472	16.414	16.356	16.299	16.240	-
FC (thousands)	300.217	302.077	303.950	305.860	307.834	-

**Note:**

There is no Table 5 in this draft determination. This is a deliberate omission that is intended to ensure consistency in Table numbers between different companies.

## 2.5 Demonstrating Compliance with the Price Controls

The Appointee shall provide such information as Ofwat may reasonably require in relation to annual regulatory reporting to demonstrate how the Appointee is complying, or has complied, with its obligation to levy charges in a way best calculated to comply with each Price Control applicable to it.

## **Appendix 1: Notified Items and Land Sales**

### **Notified Items**

Ofwat does not propose to notify the Appointee of any item that has not been allowed for (either in full or at all) when making the final determination of Price Controls.

### **Land sales**

When making the final determination of Price Controls Ofwat proposes to give notice that for each of the five consecutive Charging Years starting on or after 1 April 2020:

- the value attributable to Relevant Disposals of Land allowed for in making the determination is zero; and
- variations in value received or expected to be received from Relevant Disposals of Land shall constitute a Relevant Change of Circumstance.

## Appendix 2: In-period Outcome Delivery Incentives (ODIs)

Ofwat proposes to notify the Appointee in accordance with Part 3A of Condition B that the Price Controls to be determined in respect of the Appointee’s Retail Activities, Water Resources Activities and Network Plus Water Activities may be adjusted to reflect the Appointee’s performance in relation to the following Performance Commitments:

**Table A2.1: In-period financial performance commitments - Common PCs**

<b>Name of Common Performance Commitment</b>	<b>Type of Outcome Delivery Incentive (ODI)</b>	<b>Price controls ODIs will apply to</b>
Water quality compliance (CRI) [PR19PRT_PRT-Network Plus-01]	Financial - Under; In-period	Water network plus
Water supply interruptions [PR19PRT_PRT-Network Plus-02]	Financial - Out & under; In-period	Water network plus
Leakage [PR19PRT_PRT-Network Plus-07]	Financial - Out & under; In-period	Water network plus
Per capita consumption [PR19PRT_PRT-Water Resources 03]	Financial - Out & under; In-period	Water resources
Mains repairs [PR19PRT_PRT-Network Plus-03]	Financial - Under; In-period	Water network plus
Unplanned outage [PR19PRT_PRT-Network Plus-04]	Financial - Under; In-period	Water network plus
C-Mex: Customer measure of experience [PR19PRT_PRT-Retail-01]	Financial - Out & under; In-period	Residential retail
D-Mex: Developer services measure of experience [PR19PRT_PRT-Network Plus-11]	Financial - Out & under; In-period	Water network plus



**Table A2.2: In-period financial performance commitments - Bespoke PCs**

<b>Name of Bespoke Performance Commitment</b>	<b>Type of Outcome Delivery Incentive (ODI)</b>	<b>Price controls ODIs will apply to</b>
Water quality contacts [PR19PRT_PRT-Network Plus-06]	Financial - Under; In-period	Water network plus
Low pressure [PR19PRT_PRT-Network Plus-05]	Financial - Under; In-period	Water network plus
Catchment Management [PR19PRT_PRT-Network Plus-08]	Financial - Out & under; In-period	Water network plus
Abstraction Incentive Mechanism [PR19PRT_PRT-Water Resources-02]	Financial - Out & under; In-period	Water resources
Biodiversity (penalty) [PR19PRT_PRT-Water Resources-06]	Financial - Under; In-period	Water network plus
Voids [PR19PRT_PRT-Retail-02]	Financial - Out & under; In-period	Residential retail
Affordability [PR19PRT_PRT-Retail-03]	Financial - Under; In-period	Residential retail
Water Industry National Environment Programme [PR19PRT_NEP02]	Financial - Under; In-period	Water resources

## Appendix 3: Revenue Forecasting Incentive formula

On the assumption that an appropriate modification is made to Condition B (Charges) before December 2019, Ofwat proposes to notify the Appointee that subparagraph 8.1 of Condition B will not prevent the Appointee from levying charges to recover a Relevant Shortfall in the Charging Years beginning 1 April 2021, 1 April 2022, 1 April 2023 and 1 April 2024 (each of which will be a “Relevant Charging Year” for these purposes) where the “Relevant Shortfall” means any positive amount calculated for a Relevant Charging Year in accordance with the following formula:

### Revenue Forecasting Incentive: Water network-plus

The RFI for water network plus activities will be determined according to the following formula:

$$\begin{aligned} \mathbf{RFI}_t = & - ( \mathbf{RR}_{t-2} - \mathbf{AR}_{t-2} ) \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right)^2 \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \\ & - \mathbf{PS}_{i,t} \times \frac{\mathbf{PR}}{\mathbf{100}} \times | \mathbf{RR}_{t-2}^* - \mathbf{AR}_{t-2}^* | \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right) \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \end{aligned}$$

The RFI for water network plus activities,  $\mathbf{RFI}_t$  is added to allowed revenues for water network plus activities,  $\mathbf{R}_t$ , to calculate adjusted allowed revenues for water network plus activities, according to the following formula:

$$\mathbf{AR}_t = \mathbf{R}_t + \mathbf{BYA}_t + \mathbf{RFI}_t$$

### Revenue Forecasting Incentive: Water resources

The RFI for water resources activities will be determined according to the following formula:

$$\begin{aligned} \mathbf{RFI}_t = & - ( \mathbf{RR}_{t-2} - \mathbf{AR}_{t-2} ) \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right)^2 \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \\ & - \mathbf{PS}_{i,t} \times \frac{\mathbf{PR}}{\mathbf{100}} \times | \mathbf{RR}_{t-2}^* - \mathbf{AR}_{t-2}^* | \times \left( \mathbf{1} + \frac{\mathbf{D}}{\mathbf{100}} \right) \times ( \mathbf{1} + \mathbf{CPIH}_{t-1} ) \times ( \mathbf{1} + \mathbf{CPIH}_t ) \end{aligned}$$

The RFI for water resources, **RFI<sub>t</sub>** is added to allowed revenues for water resources, **R<sub>t</sub>**, to calculate adjusted allowed revenues for water resources, according to the following formula:

$$AR_t = R_t + BYA_t + RFI_t$$

Where for each of controls to which the RFI relates:

$$BYA_t = TBYA \times Y_t \times \left(1 + \frac{D}{100}\right)^{T-2019} \times \text{CPIH adjustment factor}_t$$

**AR<sub>t-2</sub>** The adjusted allowed revenue stated in £ millions in charging year t-2 with the first year starting on 1 April 2020.

**RR<sub>t-2</sub>\*** This has the same meaning as **RR<sub>t-2</sub>**, except in this case the relevant controls this applies to are the sum of both the water network-plus and water resource controls.

**AR<sub>t-2</sub>\*** This has the same meaning as **AR<sub>t-2</sub>**, except in this case the relevant controls this applies to are the sum of both the water network-plus and water resource controls.

**PR** The penalty rate. Denoting the forecast error  $(RR^{*t-2} - AR^{*t-2}) / AR^{*t-2} = x\%$ , the penalty rate is:

- 3% for all variations if  $|x\%| > 3\%$ ;
- $3\% * (|x\%| - 2\%) / (3\% - 2\%)$  if  $2\% < |x\%| \leq 3\%$ ;
- zero if  $|x\%| \leq 2\%$ .

The result enters the above formula as a number. For example, for a penalty rate of 3%, PR enters the formula as number 3.

**PS<sub>i,t</sub>** is the share of the penalty that the Appointee chooses to allocate to the control in charging year t,

- where i = water network-plus or water resources control; and

- the  $PS_i$  values must sum to one<sup>5</sup> for each charging year.

**BYA<sub>t</sub>** The blind-year adjustment, stated in £ millions, to the allowed revenue of the network plus control<sup>6</sup> in each year over the charging years 2021/22 to 2024/25, inclusive.

**TBYA** = Blind year adjustment stated by Ofwat in 2017/18 year average prices. Any such adjustment would be made by a future determination.

**Y<sub>t</sub>** is the percentage of the blind year adjustment that the company has elected to receive in period t of the AMP. This allows the company to spread the impact of the blind year adjustment over the relevant years. The  $Y_t$  values must

- sum to one, if the blind year adjustment is negative;
- sum to one or less, if the blind year adjustment is positive; and
- be greater than or equal to zero.

**T** = the year in which the relevant charging year begins – for example

- for the charging year 2022-23 then  $T = 2022$ ;
- for the charging year 2023-24 then  $T = 2023$ ; and
- for the charging year 2024-25 then  $T = 2024$ .

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<sup>5</sup> That is,  $PS_{\text{water resources}} + PS_{\text{water network plus}} = 1$

<sup>6</sup> The blind-year adjustments will be made to the network-plus control; it cannot be allocated to the water resources control.

## Appendix 4: Glossary

Common terms used in formulae in this document are defined below.

Term	Where used	Definition
<b>t</b>	All	A suffix added to a term to indicate the Charging Year. For example, $R_t$ refers to the relevant Charging Year.
<b>t-1</b>	All	A suffix added to a term to indicate the Prior Year. For example, $R_{t-1}$ refers to the Charging Year starting one year before the start of relevant Charging Year.
<b>t-2</b>	All	A suffix added to a term to indicate the Charging Year commencing on 1 April immediately prior to the Prior Year. For example, $R_{t-2}$ refers to the Charging Year starting two years before the start of the relevant Charging Year.
<b><math>R_t</math></b>	Network-plus, water resources,	Revenue stated in £ millions allowed to the Appointed Business in a Charging Year by a Price Control in respect of the activities concerned
<b><math>RR_t</math></b>	RFI	The revenue stated in £ millions recovered by the Appointed Business in a Charging Year in outturn prices. In the RFI, the first year, t, starts on 1 April 2022 so that year t -2 starts on 1 April 2020.
<b><math>CPIH_t</math></b>	Network-plus, water resources, RFI	The percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for the immediately preceding November.
<b>FYA CPIH</b>	Water resources	The percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and, in the case of no change, as zero) in the average level of the Consumer Prices Index (H) across the twelve months of the Charging Year compared to the average level of the Consumer Price Index (H) across the twelve months of the Prior Year.

<b><math>K_t</math></b>	Network-plus, water resources	A specified number for the relevant Charging Year which may be a positive number or a negative number or zero.
<b>D</b>	Water resources, RFI	The specified discount rate of [ <i>to be set at the final determination</i> ], which enters the relevant formula as an integer. We will use the Weighted Average Cost of Capital (WACC) that we use to set Price Controls in the final determination and apply this constantly over the period.
<b>CPIH adjustment factor<sub>t</sub></b>	Water resources, RFI,	One plus the percentage change in the Consumer Prices Index (H) between that published for the month of November in the Prior Year and that published for November 2016.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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